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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the matter of	)	
	)	
Inter-Carrier Compensation	)	CC Docket No. 99-68
for ISP-Bound Traffic	)	
	)	

AMERITECH REPLY

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Summary

The CLECs' continued pursuit of reciprocal compensation for ISP traffic is not surprising. From their perspective, such a regime is like a broken ATM machine that generates nonstop cash for minimal investment. As one independent industry analyst put it: "No other place in the sector can companies reap as much as a 4000 percent arbitrage for minimal, value- added service. No competitive market, legal or illicit, can generate such gargantuan arbitrage."

The persistence with which CLECs pursue reciprocal compensation for ISP traffic, however, cannot mask the bankruptcy of the arguments they advance in this pursuit. Reciprocal compensation for ISP traffic turns the Communications Act on its head and is antithetical to every one of the Commission's stated goals in this proceeding. It institutionalizes irrational pricing of local exchange and Internet services; reduces competition among local exchange carriers (LECs); fosters inefficient entry; skews investment incentives; and denies consumers the benefits of emerging technologies.

The central premise of the CLECs' reciprocal compensation proposal is their contention that, jurisdiction aside, ISP traffic is indistinguishable from local traffic. This argument is pointless because, from an operational and cost standpoint, local traffic is indistinguishable from FG-A access traffic, which is not subject to reciprocal compensation. It is also wrong. ISP traffic is fundamentally different from local traffic for two main reasons. First, the holding times of ISP traffic are far greater. Whereas the average local call is approximately 3.5

minutes in duration, the average Internet connection is approximately 26 minutes. Second, ISP traffic travels in one direction only, whereas most local customers send and receive calls.

As a result of the longer holding times associated with ISP traffic, it costs Ameritech, on average, just over $.02 to originate a local call, but it costs nearly $0.16 to originate a typical ISP connection. Moreover, while the costs of originating ISP traffic are greater than the costs of originating local traffic, the costs of transporting and delivering traffic to an ISP are less, on a unit basis, than the costs of transporting and terminating local traffic. Because ISPs receive so much more traffic than the typical end user, LECs can serve them more efficiently and cheaply than the average consumer. CLECs, in particular, have a unique opportunity to achieve cost savings when they serve ISPs because, as they build their networks from scratch, they can (and do) place new switches in close proximity to the largest ISPs. This enables them to save transport costs when they serve those ISPs. They can also take advantage of new technologies that save switching costs.

Although CLECs fundamentally base their reciprocal compensation proposal on a misconceived comparison of local traffic and ISP traffic, they do, as noted, make a number of other arguments, as well. These arguments, too, are flawed. For example, the assertion that CLECs should be compensated at TELRIC rates not only begs the question of who should pay that compensation, but wrongly suggests that ISP-related reciprocal compensation reflects CLEC

costs. The CLEC claim that extending reciprocal compensation to ISP traffic would drive down interconnection rates generally incorrectly implies that, ISP traffic aside, ILECs receive more in reciprocal compensation than they pay. Claims that reciprocal compensation is necessary to deny ILECs an unwarranted windfall or to validate CLEC expectations are equally specious, as is the suggestion that ISP traffic cannot be separated from local traffic.

In reality, as shown herein and in Ameritech's comments, reciprocal compensation for ISP traffic undermines the goals of the Act and every one of the stated goals of this proceeding.

First, it strips CLECs of any incentive to serve customers, including residential customers, who originate dial-up Internet access. The reason is simple: if a CLEC provides originating facilities-based local service to ordinary consumers, it not only loses the reciprocal compensation subsidy for ISP traffic, but puts itself at risk of having to pay that subsidy. As one Wall Street analyst put it, it has the "perverse effect of turning customers from assets into liabilities."

Second, reciprocal compensation for ISP traffic fosters inefficient entry and impedes efficient entry into telecommunications markets. Although ISP-related reciprocal compensation unquestionably draws CLECs to the ISP market, it does so indiscriminately – without regard to whether those CLECs can efficiently serve that market. Because it enables CLECs to look to their competitors rather than their customers for full cost recovery (and then some), it

obviates the need for CLECs to be efficient. At the same time, it denies ILECs that can serve a particular ISP more efficiently the opportunity to do so.

Third, ISP-related reciprocal compensation leads to grossly irrational pricing on every front. It compounds the losses associated with the origination of ISP traffic, while grossly overcompensating CLECs with revenues far in excess of their costs. It also breeds irrational pricing schemes for ISP services. Because CLECs recover their costs plus an exorbitant profit from the originating LEC, they are able to offer uneconomic discounts or even free access to entice ISP business. They may even pay the ISP for the privilege of locating a switch in front of the ISP server.

Fourth, ISP-related reciprocal compensation reduces the incentives of CLECs and their ISP customers to deploy advanced network capabilities, such as xDSL services. Because such compensation is available only on dial-up traffic, it encourages both CLECs and their ISP customers (with whom they share their reciprocal compensation windfall) to rely on dial-up, rather than more advanced, services.

For these reasons, the Commission should reject CLEC reciprocal compensation proposals. It should rule that, just as originating LECs must look to their own customers for cost recovery, so too should ISP LECs, rejecting inter-carrier compensation at this time.

If the Commission, nevertheless, requires originating LECs to pay inter-carrier compensation to ISP LECs, the Commission must treat such payments as

interstate costs to be recovered through interstate revenues. Although CLECs cavalierly suggest that state commissions can adjust consumer rates to address any disparity between originating LEC revenues and costs, state commissions make clear that they firmly oppose any Commission requirements that will burden intrastate ratepayers. It would be unfair and improper to place originating LECs in the middle of a jurisdictional impasse between the Commission and the states.

Finally, Ameritech notes that the comments only corroborate the point, made by Ameritech and others, that states do not have authority to impose inter-carrier compensation obligations in a section 251/252 arbitration. State authority to address interstate traffic extends, at most, to matters that fall within the scope of sections 251 and 252. But the Commission has already made clear that inter-carrier compensation is not within the scope of section 251 and 252.

TABLE OF CONTENTS

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In the Matter of	)	
	)	
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AMERITECH REPLY

I. INTRODUCTION

The Ameritech Operating Companies (Ameritech) respectfully submit this reply to comments submitted in response to the Notice of Proposed Rulemaking (*Notice*) in the above-captioned proceeding. In the *Notice,* the Commission proposes to establish rules regarding inter-carrier compensation for Internet Service Provider (ISP) traffic. The Commission's stated goal is a regime that would lead to "efficient outcomes" – *i.e.,* "ensuring the broadest possible entry of efficient new competitors, eliminating incentives for inefficient entry and irrational pricing schemes, and providing to consumers as rapidly as possible the benefits of competition and emerging technologies."[1]

Competitive local exchange carriers (CLECs) propose just the opposite. They propose a regime that has been described by the Chairman of one CLEC as a "boondoggle" that retards investment in advanced infrastructure.[2] Specifically,

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[1] *Notice* at paras. 29, 33.

[2] *Communications Daily,* Sept. 17, 1998, *quoting* Chuck McMinn, Chairman of Covad Communications.

they propose the very same reciprocal compensation regime they previously claimed - wrongly - was required by law,[3] only this time they propose it on policy grounds.

The CLECs' continued pursuit of reciprocal compensation for ISP traffic is not surprising. From their perspective, such a regime is like a broken ATM machine that generates nonstop cash for minimal investment. As one independent industry analyst put it: "No other place in the sector can companies reap as much as a 4000 percent arbitrage for minimal, value- added service. No competitive market, legal or illicit, can generate such gargantuan arbitrage."[4]

The persistence with which CLECs pursue reciprocal compensation for ISP traffic, however, cannot mask the bankruptcy of the arguments they advance in this pursuit. Reciprocal compensation for ISP traffic turns the Communications Act on its head and is antithetical to every one of the Commission's stated goals in this proceeding. It institutionalizes irrational pricing of local exchange and Internet services; reduces competition among local exchange carriers (LECs); fosters inefficient entry; skews investment incentives; and denies consumers the benefits of emerging technologies.

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[3] *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Declaratory Ruling,* CC Docket No. 96-98, FCC 99-38, released February 26, 1999 (*ISP Reciprocal Compensation Order*).

[4] *"Reciprocal Compensation for Internet Traffic—Gravy Train Running out of Track,"* Scott C. Cleland, Legg Mason Research Technology Team, June 24, 1998.

It is also contrary to precedent. While the Commission permits ISPs to purchase their access services at local rates, it is beyond dispute that ISPs are users of access services, not local services.[5] Under longstanding precedent, joint providers of access service share the revenues paid by the purchaser of that service. In fact, the Commission recognized as much in the *ISP Reciprocal Compensation Order*: "When two carriers jointly provide interstate access ... the carriers will share access revenues received from the interstate service provider."[6] Significantly, this precedent has applied to all types of access services, including Feature Group A (FG-A) service, which is precisely what ISPs use for dial-up access.[7] This precedent dictates, that, to the extent *any* inter-carrier compensation for ISP traffic is warranted, it is compensation from the LEC serving the ISP (the ISP LEC) to the originating LEC, not vice versa.

It is not just precedent, however, that dictates a sharing of the revenues paid by the ISP; as a matter of policy, such an outcome makes eminent sense. After all, the Commission did not exempt ISPs from the access charge regime in order to insulate them from having to pay cost-based access rates, but to protect what was then a fledgling industry from access rates that were significantly *above* cost.[8] A revenue sharing mechanism would place the onus on ISPs – as opposed

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5 *ISP Reciprocal Compensation Order* at para. 16.

6 *Id.* at para. 9.

7 *See Access Billing Requirements for Joint Service Provision*, 4 FCC Rcd 7183, 7185-86 (1989).

8 As GTE points out, the access charge exemption was initially adopted to protect what was then a nascent industry from access charges that were well in excess of ten cents per minute

to originating end users – to cover the costs of the access services the ISPs use. That would, in turn, permit meaningful competition among LECs for ISP customers (since the LEC with the lowest cost would be more successful in the marketplace), thereby driving the "local" rates paid by ISPs to cost. That is the efficient outcome the Commission seeks, not a reciprocal compensation regime in which originating LECs – and, by extension, the ordinary consumers they serve – finance a "free ride" for the likes of AOL, IBM, AT&T, and MCI WorldCom.

Of course, Ameritech is not so naïve as to expect that the Commission will require ISP LECs to share the revenues they receive from their ISP customers, and, for that reason, Ameritech does not ask the Commission to do so in this proceeding. Surely, however, if ISPs are not expected to pay the *full* cost of the access services they use, they at least ought to cover the costs of the services they receive from their own LEC. Thus, if the Commission does not require revenue sharing, it should require each LEC to look to its own customers for cost recovery, without depending upon compensation from the other. Next to a revenue sharing arrangement, such a regime would best encourage rational pricing of ISP access and Internet services, promote efficient entry and investment, increase competition among LECs both for ISPs and residential consumers, and spur deployment of advanced services.

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on each end of a call. GTE Comments at 3. More recently, in deciding to retain the exemption, the Commission pointedly observed that access charges were not yet cost-based and indicated its unwillingness to impose such non-cost-based rates on ISPs. *Access Charge Reform*, 12 FCC Rcd 15982, 16133 (1997).

II. ARGUMENT

A. CLEC Policy Arguments are Flawed. Reciprocal Compensation for ISP Traffic is, in Fact, Antithetical to the Goals of the Communications Act and the Stated Goals of this Proceeding.

While CLECs scrupulously avoid anything more than the briefest reference to the overarching goals of the Communications Act and the stated goals of this proceeding, they do offer a hodge-podge of arguments in a vain effort to demonstrate that reciprocal compensation for ISP traffic is warranted on policy grounds. Their principal argument is that, jurisdiction aside, ISP traffic is indistinguishable from local traffic and, accordingly, should be subject to the same compensation rules. They argue, further, that a reciprocal compensation regime for ISP traffic would serve the public interest by: (1) compensating ISP LECs at the preferred total element long run incremental cost (TELRIC) rates; (2) creating incentives for ILECs to reduce reciprocal compensation rates; (3) denying ILECs an undeserved windfall from cost savings derived from the CLECs' role in the process; (4) protecting CLEC expectations of continued reciprocal compensation revenue; and (5) avoiding the costs associated with distinguishing ISP traffic from local traffic.[9] As discussed below, these

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[9] Time Warner and ALTS also contend that it would be unreasonably discriminatory for an ILEC to refuse to pay reciprocal compensation for ISP traffic. Time Warner Comments at 1-14; ALTS Comments at 12. This argument is fatuous. The obligation to pay reciprocal compensation derives from the Communications Act, as amended by the Telecommunications Act of 1996 (the Act). The Commission has found that the Act does not require the payment of reciprocal compensation for ISP traffic. Quite obviously, a LEC could not be found to violate the nondiscrimination provisions of the Act by adhering to the reciprocal compensation provisions of the Act. Moreover, Time Warner's purported application of the three-part test used in discrimination claims is flawed. First, ISP traffic is not like local traffic for the simple reason that ISP traffic belongs to a completely different category of traffic: access traffic. Moreover, as shown below, ISP traffic is quite different from local traffic, both from an operational and cost

arguments are meritless. Rather than promoting the goals of the Act and this proceeding, reciprocal compensation for ISP traffic would impede those goals.

1. Analogies to Local Traffic are Pointless and Wrong.

As noted, the central premise of the CLECs' reciprocal compensation proposal is their contention that, jurisdiction aside, ISP traffic is indistinguishable from local traffic. They claim, in particular, that, from an operational and cost standpoint, the origination, transport, and delivery of ISP traffic and local traffic are the same.[10]

This argument is wrong. ISP traffic is fundamentally different from local traffic for two main reasons. First, the holding times of ISP traffic are far greater. Whereas the average local call is approximately 3.5 minutes in duration, the average Internet connection is approximately 26 minutes.[11] Second, ISP traffic

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standpoint. Second, these differences aside, ILECs do not discriminate against CLECs by not paying reciprocal compensation for ISP traffic since ILECs do not pay ISP-related reciprocal compensation to any LEC. Third, even assuming *arguendo* the existence of discrimination, that discrimination would hardly be unreasonable. It has long been recognized that discrimination is reasonable if justified by cost differences. *See, e.g. Eastern-Central Motor Carrier Ass'n v. United* States, 321 U.S. 194 (1944); *L.T. Barringer Co. v. United* States, 319 U.S. 1, 13-14 (1943); MCI *Telecommunications Corp. v. FCC*, 917 F.2d 30, 39 (D.C. Cir. 1990); *Sea-Land Service, Inc. v. ICC*, 738 F.2d 1311 (D.C. Cir. 1984); *Dresser Industries, Inc. v. ICC*, 714 F.2d 588, 599-602 (5th Cir. 1983); *AT&T v. FCC*, 449 F.2d 439, 449-450 (2nd Cir. 1971). The cost of originating an ISP connection, even without reciprocal compensation, is much higher than the cost of originating a local call. That, in itself, renders reasonable the non-payment of reciprocal compensation for ISP traffic. The fact that reciprocal compensation for ISP traffic is also much more costly than reciprocal compensation for local traffic renders such actions all the more reasonable.

[10] *See, e.g.* Lightpath Comments at 6-7; MCI WorldCom Comments at 10-11; KMC Telecom Comments at 4; ALTS Comments at 13; Time Warner Comments at 9; CompTel Comments at 3; AT&T Comments at 10-12; Cox Communications Comments at 6-7

[11] Studies conducted by two Telephone Association of New England (TANE) members are consistent with Ameritech's findings that the average Internet connection is 26 minutes. Those studies, which compared January 1997 and January 1999 traffic found that Internet sessions averaged 27 minutes in duration. They found, further, that the average holding time per call has more than doubled during this time. TANE Comments at 2. On the other hand, some

travels in one direction only, whereas most local customers send and receive calls.

CLECs purport to dismiss these distinctions. Citing ticketing agencies,[12] radio call-in shows,[13] pizza delivery services,[14] credit card services,[15] airline reservation services,[16] catalog merchants,[17] and even chatty teen-agers,[18] they claim that long holding times and one-way traffic patterns, are not unique to ISP traffic.

These examples are neither comparable nor relevant. As an initial matter, many of the entities cited above do not rely on local service to connect to their customers; they use toll-free and other interstate services, which *they pay for*. Moreover, to the extent these entities do receive local calls, that traffic is not at all similar to Internet traffic. While ticket agents, pizza parlors, catalog merchants, etc., all tend to receive far more calls than they make, the analogy stops there: millions of consumers do not spend 39 hours per month every month ordering

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commenters contend that the average Internet session is longer. For example, Cincinnati Bell cites evidence suggesting that the average Internet session is 36 minutes. Cincinnati Bell Comments at 2-3, *citing Internet Basics*, Vol. 5, Issue 3, "Online Tidbits." If this data is correct, obviously the differences between ISP traffic and local traffic are even more pronounced.

[12] ALTS Comments at 13; Time Warner Comments at 13.

[13] ALTS Comments at 13; Time Warner Comments at 13.

[14] ALTS Comments at 13; Cox Communications Comments at 9.

[15] Time Warner Comments at 13; AT&T Comments at 13; Lightpath Comments at 8.

[16] Time Warner Comments at 13.

[17] Time Warner Comments at 13; KMC Comments at 4.

[18] RCN Telecom Services Comments at 3; Cox Communications Comments at 9.

tickets, pizza, or making plane reservations, and even the most pathological shopaholic does not spend 39 hours per month on the telephone ordering merchandise from catalogs.[19] And while (stereotyping aside) some teen-agers may spend long hours on the phone, there is no reason to believe that these teen-agers do not place calls as often as they receive them.

Moreover, even if these examples were comparable – which they are not – they prove nothing. These examples are not typical local calls; they are the exception. Reciprocal compensation is paid on these calls (to the extent that they are local) because the statute requires it, not because it is inherently efficient to do so. Thus, these examples present no *policy* basis for extending reciprocal compensation to ISP traffic. To suggest that reciprocal compensation should be paid on billions of Internet access minutes each month because reciprocal compensation must, by law, be paid on calls to pizza parlors and the like is just silly.[20]

In fact, an overall comparison of ISP traffic and local traffic underscores the point that ISP traffic is fundamentally different from local traffic. For example, while CLECs claim that "[n]one of the distinctions between ISP calls

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[19] A study conducted last year by Ziff Davis of 50,000 households found that the average AOL user is online about ten hours per week, while the average user of other ISP services is online about 8.5 hours per week. Thus, the average AOL user is online about 43 hours per month, while the average user of other ISP services is online about 36 hours per month. *See "AOL and ISP Users are a Different Breed,"* Aaron Goldberg, Executive VP ZD Market Intelligence, Aug. 11, 1998, http://www.zdnet.com/anchordesk/story/story_2409.html.

[20] *See* AT&T Comments at 14 ("it would plainly be improper for the Commission to base its general rule on the exceptional case.")

and average calls relate to a cost difference for handling those calls[,]"[21] that is simply not true. As Attachment A shows, it costs Ameritech, on average, just over $.02 to originate a local call,[22] but it costs nearly $0.16 to originate a typical ISP connection.[23] This seven-fold cost difference reflects the substantially longer holding times of ISP traffic.

Equally specious are CLEC claims that the costs of transporting and delivering traffic to an ISP are no different from the cost of transporting and terminating local traffic. Because ISPs receive so much more traffic than the typical end user, LECs can serve them more efficiently and cheaply than the average consumer. CLECs, in particular, have a unique opportunity to achieve cost savings when they serve ISPs because, as they build their networks from scratch, they can (and do) place new switches in close proximity to the largest ISPs. This enables them to save transport costs when they serve those ISPs. They can also take advantage of new technologies that save switching costs.

These cost savings are described in detail in the comments submitted by Global NAPs. As Global NAPs explains, CLECs do not merely locate their

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[21] Cox Communications Comments at 7, *quoting* statement of Gerald W. Brock, attached thereto as Exhibit 2, at 1 (hereinafter "Brock Statement").

GST Telecom claims "[t]here is no evidence that the longer holding times of Internet calls significantly affect the average per minute costs of those calls." GST Telecom Comments at 17. Ameritech does not claim that its per-minute costs are higher; rather, it shows that its per-call costs are higher.

[22] Specifically, it costs $.0210 in Illinois; $.0201 in Indiana; $.0215 in Michigan; $.0197 in Ohio; and $.0224 in Wisconsin.

[23] To originate an ISP connection costs, on average, $.1562 in Illinois; $.1491 in Indiana; $.1596 in Michigan; $.1467 in Ohio; and $.1663 in Wisconsin.

switches in close proximity to ISPs; they allow ISPs to collocate in CLEC switching facilities, thereby avoiding what Global NAPs characterizes as "huge transmission costs."[24]

These savings are also described by GTE. GTE notes that new SS7 bypass devices permit calls to selected telephone numbers (*e.g.* ISPs) to be directly transported to their destination, thereby avoiding circuit-switching altogether. It notes further that, according to media descriptions, this can reduce a carrier's costs by a factor of ten.[25]

It is undoubtedly these types of savings that enabled Global NAPs to collect $3.125 million in reciprocal compensation payments from Bell Atlantic during the first quarter of 1998 in Massachusetts on direct costs of only $267,000.[26] The fact that these revenues also happened to represent 99% of Global NAPs' revenues for that quarter is a matter that will be discussed later.

Ameritech does not begrudge CLECs these cost savings. Indeed, the whole point of competition is to drive efficiency. What Ameritech objects to on

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[24] Global NAPs Comments, Exhibit 1, Statement of Fred Goldstein, at para 6. Although Global NAPs maintains that CLECs, but not ILECs, treat ISPs as valued customers, and that CLECs consequently offer ISPs superior service, it argues that CLECs will be unable to penetrate the ISP market effectively if reciprocal compensation for ISP traffic is unavailable. *Compare* Global NAPs Comments at 3 *with id.* at 6. These comments are internally inconsistent claims. If CLECs really do offer ISPs better service, they will continue to win the business of ISPs even if they are denied the subsidy that enables them to woo ISPs with "artificial sweeteners."

[25] *See* GTE Comments at 7, *citing* "ISPs Strongarm GTE; UUNet Others Demand SS7 Bypass Savings," *ISP Business News*, Nov. 9, 1998 at 1 (describing SS7 bypass equipment manufactured by Ascend Communications); Competitive Carrier Strategies II Workshop, Ascend, http://www.ascend.com/3536.html (offering seminars suggesting "Solutions for turning recent regulations [including the FCC reciprocal compensation decision] into profit opportunities."

[26] Bell Atlantic Comments at n. 2.

the strongest terms is the notion that Ameritech ought to pay for the service these CLECs provide to ISPs. If, indeed, a CLEC offers a cheaper, more efficient service, it should be able to win an ISP's business *on the merits*. It hardly needs a subsidy from an ILEC to do so. At the same time, in order for competition truly to flourish, and in order for ISPs to continue to reap the benefits therefrom, ILECs too must be given a fair opportunity to compete for ISP business. Reciprocal compensation forecloses that opportunity. When one LEC can offer a service that is fully financed by its competitor, that LEC will win the competitive battle every time. And let there be no mistake: CLEC claims notwithstanding, this is not a reciprocal opportunity. CLECs have exhibited little interest in serving residential subscribers, not only because business customers are far more profitable, but because of the perverse incentives created by ISP reciprocal compensation (another matter discussed *infra*). Consequently, ILECs have little opportunity to collect reciprocal compensation for ISP traffic even when they win the business of an ISP. That makes it extremely difficult for them to do so.

In any event, the CLECs' assertion that the only distinction between local traffic and ISP traffic is a jurisdictional one is not only wrong, but pointless. From an operational and cost standpoint, local traffic is indistinguishable from FG-A access traffic. The only distinction between them is that local traffic terminates at the point of delivery while FG-A traffic does not. In other words, the two are different only in what takes place *after* the traffic has left the LECs'